

## Internal Revenue Service

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In Re: letter ruling request

## Department of the Treasury

Washington, DC 20224

[Third Party Communication:

Date of Communication: Month DD, YYYY]

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Date:

April 28, 2011

### LEGEND:

Taxpayer =

Supplier =

Factor =

Regulator =

Products =

Type A =

Country B =

C =

D =

E =

F =

G Amount =

H =

J Amount =

K =

Type L =

Date M =

Date N =

Entity P =

Entity Q =

Entity R =

Entity S =

Type T =

Dear \_\_\_\_\_ :

This is in response to a letter dated October 29, 2010 requesting rulings that (1) any income recognized by one of Taxpayer's controlled foreign corporations from factoring certain receivables not previously included in income does not arise from the sale or exchange of property within the meaning of Code section 954(c)(1)(B), and (2) because such income is not subpart F income within the meaning of section 952(a), the Taxpayer is not required to report currently any share of such income under section 951.

The rulings contained in this letter are based upon the information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data submitted may be required as part of the audit process.

#### STATEMENT OF FACTS

The facts, representations, and conditions set forth in Taxpayer's submission are as follows.

Taxpayer and its U.S. affiliates (collectively, Taxpayer) file a consolidated federal income tax return, and use an accrual method of accounting and a calendar taxable year. One of Taxpayer's Country B affiliates, Supplier, is one of the C industry's suppliers of Products. Supplier's business receipts are derived from the sales of Products and associated services, including D.

Supplier's contracts provide for payment at contractually based "milestones." For example, a contract may require the customer to pay E% when the contract is signed; F% when Supplier has completed G Amount of the work; H% when Supplier has completed J Amount of the work; and the final K% when title passes to the customer. Upon reaching a milestone, Supplier sends an invoice to the customer, creating a Type L receivable, which is paid by the customer at a later date.

Supplier recognizes revenue on the accrual method for financial accounting, in accordance with U.S. generally accepted accounting principles (GAAP). Supplier also uses accrual accounting for tax purposes, and has further elected to defer advance payments under Revenue Procedure 2004-34, 2004-1 C.B. 991. As a result, Supplier's revenue recognition for U.S. tax purposes is largely independent of its contractually based milestones or when its Type L receivables arise. Whenever Supplier's Type L receivables arise before revenue is recognized for U.S. tax purposes, Supplier's Type L receivables will have zero basis for U.S. tax purposes.

In order to accelerate the receipt of cash, Supplier often factors its receivables, including its Type L receivables. This factoring is generally done with a related party, as described below, and may result in an acceleration of income to Supplier.

Supplier is a controlled foreign corporation of Taxpayer. Supplier acquired the outstanding shares of Factor in Date M. Factor has been a disregarded entity for U.S. tax purposes throughout the period of ownership by Supplier. Factor factors Supplier's Type L receivables. Currently, this factoring program has no U.S. tax consequences because of Factor's U.S. tax status as a disregarded entity wholly owned by Supplier.

On Date N, Entity P (one of the component members of Taxpayer) -- through its wholly-owned Country B subsidiary, Entity Q -- acquired the outstanding shares of Entity R from unrelated Entity S. The Regulator has required Taxpayer to commit to transferring other Country B Type T subsidiaries into the Entity R ownership chain. Taxpayer is considering transferring either the Factor business (by way of asset transfer or business migration) or the Factor stock into the Entity R ownership chain. Doing so would be welcomed by the Regulator and would align Country B tax losses in the Entity R consolidated group with profits in Factor.

Whichever form of transfer takes place, the Factor-Supplier factoring activity would cease to be disregarded for U.S. tax purposes as occurring entirely within one entity; that is, the factoring transactions would become recognized as transactions between Supplier and the entity to which the Factor business or stock (assuming Factor remains a disregarded entity) is transferred. Taxpayer nonetheless would like Supplier to continue the factoring program with Factor or its successor.

Taxpayer makes the following additional representations (which are limited to the contracts and transactions with respect to which it seeks these rulings):

- The contracts from which the Type L receivables arise are not subject to the long-term contract accounting rules of section 460;
- The contracts from which the Type L receivables arise would not produce foreign base company sales income (FBCSal) under section 954(d) nor foreign base company services income (FBCSel) under section 954(e);
- The Type L receivables do not bear interest by their terms, and interest would not be imputed under sections 483 or 1274;
- The factoring transaction is properly treated for U.S. income tax purposes as a sale of the Type L receivables and not a borrowing; and
- The factoring transaction does not result in the acceleration of income for purposes of U.S. financial reporting, Country B financial reporting, or for Country B tax purposes.

## LAW AND ANALYSIS

Code section 951(a)(1)(A)(i) requires a United States shareholder of a controlled foreign corporation ("CFC") to include in gross income its pro rata share of the CFC's subpart F income for the taxable year.

Code section 951(b) defines the term "United States shareholder" to mean, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

Code section 957(a) defines a CFC to mean any foreign corporation if more than 50 percent of the total combined voting power of all classes of its stock or more than 50 percent of the total value of its stock is owned (within the meaning of section 958) by United States shareholders on any day during the taxable year of such foreign corporation.

Code section 952(a) defines subpart F income to include, among other things, foreign base company income as determined under section 954.

Code section 954(a) defines four categories of foreign base company income, two of which are foreign personal holding company income (FPHCI) as determined under section 954(c) and FBCSI as determined under section 954(d).

Under Code section 954(c)(1) and Treas. Reg. § 1.954-2(a)(1), FPHCI consists of (subject to certain exceptions): (1) dividends, interest, rents, royalties and annuities; (2) gain from certain property; (3) gain from commodities transactions; (4) foreign currency gain; and (5) income equivalent to interest.

Code section 954(c)(1)(B)(iii) provides that FPHCI includes the excess of gains over losses from the sale or exchange of property that does not give rise to any income. "Sale or exchange" is not defined for purposes of section 954(c)(1)(B). Under Treas. Reg. § 1.954-2(e)(3), the term "property that does not give rise to income" includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options.

Taxpayer has represented that Supplier's contracts from which the Type L receivables arise would not produce FBCSal or FBCSel. Under the facts as presented by Taxpayer, the only other category of subpart F income that the factoring of its receivables would potentially produce is FPHCI, namely gain from the sale or exchange of property that does not give rise to any income under section 954(c)(1)(B)(iii).

Thus, the issue is whether the factoring of such receivables converts into FPHCI otherwise non-subpart F income earned by Supplier in its business of selling Products

and related services. We do not believe that such factoring converts Supplier's income into FPHCI.

Rather, any accelerated income received by Supplier as a result of factoring Type L receivables is a substitute for the income it would have collected under the relevant contracts, and should retain the same (non-subpart F) character. See, e.g., *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 265, 78 S.Ct. 691, 694 (1958) (where lump-sum payments are received in exchange "for what would otherwise be received at a future time as ordinary income," the payments should be treated as ordinary income rather than capital gains); *Prebola v. Commissioner*, 482 F.3d 610, 611 (2d. Cir. 2007), citing *Watkins v. Commissioner*, 447 F.3d 1269, 1272 (10<sup>th</sup> Cir. 2006) (the "basic lesson" of the substitute-for-ordinary-income line of cases following *P.G. Lake* is that "when a party exchanges for a lump sum the right to receive in the future ordinary income already earned or obtained, the amount received serves as a substitute for the ordinary income the party had the right to receive over time" and the lump sum is ordinary income).

## RULINGS

Based solely on the facts, information and representations submitted, we conclude that, for purposes of subpart F (1) any income that Supplier may recognize from factoring Type L receivables not previously included in income represents an acceleration of income from the underlying customer contracts and does not arise from the "sale or exchange of property" within the meaning of section 954(c)(1)(B), and (2) Taxpayer is not required to report any share of such income currently under section 951.

## DISCLAIMERS

The above rulings shall have no effect on the treatment of the proceeds of factoring any receivable to the extent that receivable has already been taken into account, and the associated income recognized, for U.S. tax purposes.

The above rulings shall have no effect on the treatment of any income that Supplier may recognize in excess of the amount that Supplier would have recognized from a full collection of all amounts due under the contract. Any such excess is to be calculated in Supplier's functional currency, as of the date(s) on which Supplier recognizes income, and with appropriate adjustments for previously recognized income relating to the same contract.

The above rulings shall have no effect on any application of section 909 of the Code to the Taxpayer.

No ruling has been requested, and none is expressed, as to the application of any other section of the Code or regulations to the facts presented.

This ruling letter is directed only to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file in this office, copies of this ruling letter are being sent to Taxpayer's authorized representatives.

Sincerely,

Jeffery G. Mitchell  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(International )